Financial Freedom

QUARTER 1 2015

NEWSLETTER

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- **Retirement planning**
- **Personal insurances**
- **Investments**
- **UK pension transfers**
- **Business protection insurance**

INSIDE THIS ISSUE:

	PAGE
G3 Financial Freedom editorial	2
Check your PIR	2
Active versus passive	3
Active versus passive continued	4
Insert - Budget table	

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An Economy Of Ups And Downs

"Geopolitical risks are again a key concern in regard to oil prices. In the case of Iraq, an escalation in the internal conflict could lead to disruptions in the country's (as well as global) oil production. This possibility could lead to adverse global spillovers to other economies through higher oil prices, lower risk appetite in global financial markets, and lower confidence more broadly.[1]"

In October 2014, the International Monetary Fund considered the situation the world was in, and reported that there was a risk of a spike in oil prices, and analysed the implications. By their calculations (and depending on the scenario used), world GDP could decline by up to 1.5% (a massive amount). At that point, oil was trading in the US$90/barrel range. By January 2015, oil had fallen below US$50/barrel.

The point of this is not to highlight the difficulty of making accurate predictions, but rather to illustrate how sudden changes can occur and look at the implications.

At a high level, countries such as the US, India and China are seen to be winners when oil prices drop. Countries such as Venezuela, Russia, Iraq and Iran are seen as losers. In some cases, such a broad analysis is acceptable, but you can get different answers when you go into more detail.

Take the US – it's been estimated that the drop in oil prices is equivalent to a US$125 billion tax cut. Some families will save over US$700 in heating bills this winter. However part of the drop in oil prices is due to the massive increase in shale oil and gas production by the US. In a nutshell, the US has managed to massively increase its production of oil at a time when there is less demand for oil, which leads to an oversupply and therefore lower oil prices.

Shale oil and gas from the US is relatively expensive to produce, so when the price dropped rapidly, the producers started losing money . As a result, oil producers are cutting their spending, affecting the US economy. The Manhattan Institute, a US based organisation, estimates that as many as 10 million jobs in the US depend, in whole or part, on shale oil.[2]

It isn't just oil producers who are affected. Lower oil prices have seen an increase in large vehicle sales, but hybrid cars are harder to sell. Airlines are expected to prosper as costs fall, but companies selling solar panels and alternative energy sources will face hard times. As one industry falls, another rises – it really is an economy of ups and downs.

This only briefly covers the impact of one commodity price falling. There are also other equally important concerns such as the conflicts in Iraq/Syria, and Ukraine, Greece's requests for debt remission, relations between China and Japan, and domestically the falling commodity price for milk.

With these ups and downs happening at the same time, investors need to be able to minimise their portfolio's exposure to catastrophic losses, but also ensure that they participate in the gains. A well diversified portfolio does both these tasks. You are not exposed to large losses from these unpredictable events as a diversified portfolio is designed to limit your exposure to this type of risk. Your portfolio will allow you to participate in the gains made by a myriad of companies.

You will only gain these benefits if your portfolio is actually well diversified. A financial adviser can assist in determining this, so you know what risks you are actually exposed to, even when you aren't sure what the future holds.

[1] WORLD ECONOMIC OUTLOOK: LEGACIES, CLOUDS, UNCERTAINTIES – October 2014, IMF

[2] Power & Growth Initiative Report No.4, February 2014, Manhattan Institute

Article by IOOF New Zealand Limited

G3 Financial Freedom Editorial from the desk of Cathy Fletcher (G3 Office Manager)

I am still a newspaper subscriber. However, I have a feeling we may be a dying breed. I also love books and for me the electronic media won't replace the feel of the turning of the pages and dreaming while I am lost in the pictures. In my Bay of Plenty Times paper on Tuesday 3rd of March was an article about billionaire Warren Buffett and how proud he is of his company Berkshire Hathaway although now it is a publicly listed company. Mr Buffett is the CEO of Berkshire Hathaway, a company he started very early in his life. With some risk taking, hard work and nous he has built this company into an American multinational conglomerate. The article mentioned that he had made mistakes and some of those mistakes were extraordinarily expensive, as in the many millions of dollars expensive, including losing $440 million on its investment in Tesco, the British company. But there were two things in this article that really stood out to me and I quote " One of the best ways to build wealth over time is to own stocks, but Mr Buffett said investors must avoid the common mistakes of trading too often and paying high investment fees." And the other quote " Market forecasters will fill your ear but will never fill your wallet, Mr Buffett said". This reminded me that those two excerpts are also the philosophy of G3 Financial Freedom. That is what we do for our clients, keep the fees down, follow the passive investing regime and keep our clients focused on achieving the wealth they need to accumulate to have a retirement that was worth working for.

As we start the new tax year, now is a really good time to do or revise your budget. I have included our budget sheet to help you remember what all the little extras are that add up over time. Budgeting is important to ensure you meet your existing commitments and still have something left to save. You will know and understand exactly where your money goes. It is the first rule of good money management.

Make the most of this beautiful weather we are having - all too soon it will be winter

31 March - Time To Check Your PIR

What is a PIR? This is your Prescribed Investor Rate – the rate at which the IRD tax your returns on any investments in a PIE structure (Portfolio Investment Entity) you have.

Anyone who has a KiwiSaver has a PIE investment therefore, it is important to check that the PIR is correct. The last thing you want to be doing is paying more tax than you need to, or not paying enough and potentially risking the wrath of the IRD.

Below is a table you can use to workout which rate is correct for you for this coming tax year. You take the lower of your taxable income + PIE income for the previous two tax years = PIR. Your PIR is not necessarily the same as your income tax rate.

If you are not sure what your rate is currently, you could log in to your KiwiSaver investment or, if your PIE/KiwiSaver investment has been done via G3 Financial Freedom, we can help you check it and update it if necessary.

Income tax rates and Prescribed Investor Rates – Individuals & Joint

Taxable income			Income Tax Rate	Taxable income + PIE income	PIR
$0	to	$14,000	10.5%	<$14,000 + PIE Income <$48,000	10.5%
$14,001	to	$48,000	17.5%	$14000 - $48,000 Taxable income +PIE <$70,000	17.5%
$48,001	to	$70,000	30.0%	>$48,000 combined Taxable + PIE Income	28.0%
$70,000+			33.0%		

Criteria for PIR rate – income in either of the 2 previous income years and a valid IRD number has been provided.

Start where you are.

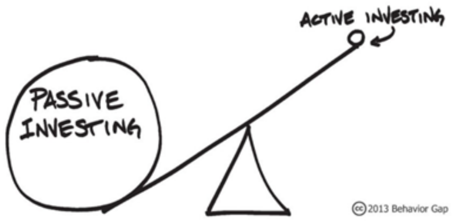
Use what you have.

Do what you can

Arthur Ashe

Active Versus Passive - The Debate Is Over

At G3, we believe a growing body of evidence has moved us past the traditional active vs. passive debate. The best evidence comes from the US where the research has been collected and mostly aptly documented. The traditional debate contrasts an index fund, representing the passive camp, and an active equity or hedge fund, representing the active camp.



A widely publicised wager between Warren Buffett and a hedge fund manager called Protégé Partners illustrates the point. Buffett bet that the Vanguard S&P 500 (a passive index type fund) would beat a selected group of hedge funds over a 10 year time horizon. So far the Vanguard fund is up 43.8%, compared with the hedge fund's gain of just 12.5% since the bet was made.[1]

Buffett's backing of the S&P 500 was primarily an argument about the significance of cost minimisation not philosophy. In his 2014 Berkshire Hathaway letter to shareholders, Buffett said he had instructed his estate to put 90% of his funds into the Vanguard S&P 500 and 10% in cash. Here's his rationale:

The very first step to building wealth is to spend less than you make

Brian Koslow

"Both individuals and institutions will constantly be urged to be active by those who profit from giving advice or effecting transactions. The resulting frictional costs can be huge and, for investors in aggregate, devoid of benefit. So ignore the chatter, keep your costs minimal…

-Warren Buffett.
2013 Berkshire Shareholder Letter
Page 6

This observation, from one of the greatest stock pickers in history, suggests that one does not necessarily need to agree with a passive investment philosophy to observe the weight of the evidence. The evidence shows, overwhelmingly, that investors are not rewarded by the high costs of active investment management.

When Russell Kinnel, director of research at Morningstar, attempted to identify the number one predictor of performance for investment managers, his findings also made a compelling argument in favour of low cost investing.

[1] In USD terms as at 06/02/2014, approximately six years into the wager

"If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision. In every single time period and data point tested, low-cost funds beat high-cost funds. . . . Investors should make expense ratios a primary test in fund selection. They are still the most dependable predictor of performance."

-Russell Kinnel.
Director of Mutual Fund Research, Morningstar
Morningstar FundInvestor, vol. 18, no. 12 (August):1–3.

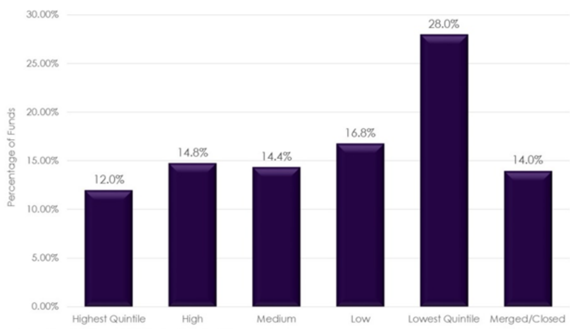
The second part of the debate focuses on persistence in performance. Every study of the persistence of active managers to deliver outperformance (and there have been plenty) shows that, once you control for risk, there is no statistically meaningful performance persistence.

To illustrate simply, Vanguard conducted a study in which they ranked all US equity funds in terms of excess return versus their stated benchmark over the five years ending 2008. They divided the funds into quintiles, separating out the top 20% of funds. They then tracked the performance of those top 20% of funds over the following five years through December 2013 to check for persistence. If the top quintile funds displayed any meaningful performance persistence, we would expect a significant majority to remain in the top 20% five years later. A random outcome would result in about 20% of the funds dispersed evenly across the five quintiles.

The results were close to random. Only 12% of funds repeated a top quintile performance, while 28% moved to the bottom quintile.

If costs really matter and performance persistence by active managers cannot be counted on, is there a reliable way to outperform markets?

How the top 20% of US Funds from 2004 - 2008 ranked in the subsequent five years 2009 to 2013.



Source: Figure 7. "The case for index-fund investing" Vanguard
https://pressroom.vanguard.com/content/nonindexed/Updated_The_Case_for_Index_Fund_Investing_4.9.2014.pdf

This is where we depart from the traditional passive vs. active discussion. Considerable research shows that low cost shares (based on a combination of fundamental ratios), small company shares and profitable company shares exhibit higher returns than the market over long periods of time.

Continued over the page

Active Versus Passive - The Debate Is Over - *continued*

Life is an error-making and an error-correcting process

Jonas Salk

The figure below compares long term value, small cap, growth and total market indices for various markets.

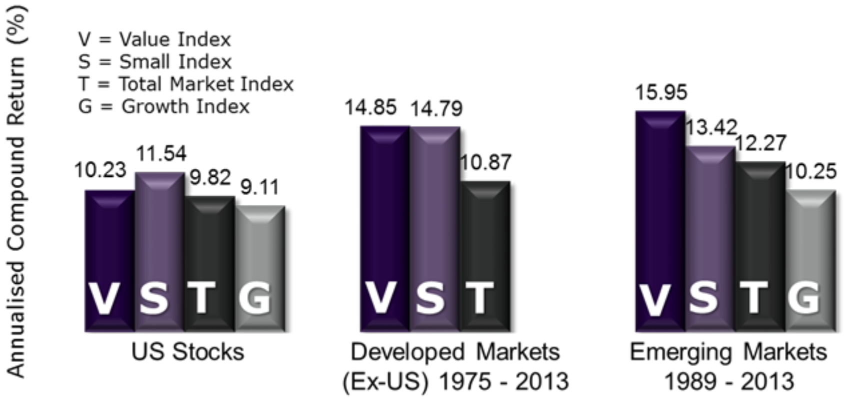
Both value and small cap segments of the market outperform total market and growth. The implications of this are that not every share has the same expected return. This is probably because shares incorporate unique systematic risks, for which prices and market capitalisation are merely a proxy. And there are other proxies beyond just these two. The question is how to invest in shares with a higher expected return. Do we pay a manager to pick what he believes are the best of the bunch?

Two problems arise with this approach - the manager's fee (evidence shows this is not money well spent) and also that we lose some of the virtually costless benefits of diversification.

Passive investors can defeat both of these problems. They can use very low cost and highly diversified funds to access these sources of higher expected returns in a way that adds long term value over broad market benchmarks and peers. In everything we do, the core of the argument is always evidence. We want to see evidence - evidence that has some statistical relevance; evidence that is persistent across time periods, pervasive across markets and has a sound economic rationale to it. We want to see evidence that ideas don't work merely in theory or on paper, but can produce results after considering the costs of management, transactions and taxes. The problem with active management as it's traditionally described is that the evidence simply doesn't stack up.

As for the debate about active vs. passive… If it's purely an argument based on conjecture and opinion, it will probably never end. However, if evidence counts for anything, we think this debate was settled a long time ago.

If you would like more information we have a booklet available, Evidence Based Investing. Send an email to *admin@g3freedom.co.nz* and we can send one to you.



Annual Returns are from January to December. US large, US small, non-US developed, and emerging markets stocks in US Dollars. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. US value and growth index data (ex utilities) provided by Fama/French. The S&P data are provided by Standard & Poor's Index Services Group. CRSP data provided by the Center for Research in Security Prices, University of Chicago. International data provided by Fama/French from Bloomberg and MSCI securities data. MSCI EAFE Index is gross of foreign withholding taxes on dividends; copyright MSCI 2013, all rights reserved. Emerging Markets index data simulated by Fama/French from countries in the IFC Investable Universe; simulations are free-float weighted both within each country and across all countries.

G3 FINANCIAL FREEDOM
Goals + Guidance = Growth

G3 Financial Freedom Ltd

55 Eighth Avenue

PO Box 13563

TAURANGA 3141

Phone: 07 571 5333
Fax: 07 571 5339
Email: admin@g3freedom.co.nz

G3 Financial Freedom Ltd - We Make Every Day Count

We are the financial advice company that can help you create the financial future you desire with peace of mind, security and confidence. We operate under the rules of the Financial Markets Authority and abide by the Financial Advisers Act 2008. We are voluntary members of the New Zealand Institute of Financial Advisers.

We are all Certified Financial Planners, Chartered Life Underwriters, Accredited Investment Fiduciaries and we are all Authorised Financial Advisers. Talk to us about your financial future now. It is never too late to begin.

A Disclosure statement relating to the financial advisers associated with this newsletter is available on request and free of charge.